Court of Appeal File No. M41654
Superior Court File No. CV-12-9667-00-CL

COURT OF APPEAL FOR ONTARIO

IN THE MATTER OF THE *COMPANIES CREDITORS' ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT IN THE MATTER OF SINO-FOREST CORPORATION

Applicant

APPLICATION UNDER THE *COMPANIES CREDITORS' ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

FACTUM OF ERNST & YOUNG LLP

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LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant,
Ernst & Young LLP

TO: **THE SERVICE LIST**

FACTUM OF ERNST & YOUNG LLP

PART I - THE APPEAL

1. This is an appeal by Ernst & Young LLP ("**E&Y**") with leave of this Honourable Court from the order of the Honourable Justice Morawetz dated July 27, 2012 (the "**Order**") that the claims of E&Y against the Applicant, Sino-Forest Corporation ("**SFC**", the "**Company**" or the "**Applicant**") for contribution and indemnity (other than defence costs) related to or arising out of the claims of shareholders in the Class Actions against E&Y (as defined below) are "equity claims" as defined in section 2 of the *Companies Creditors' Arrangement Act* (the "**CCAA**").

2. E&Y asks that the Order of Justice Morawetz be set aside and an order be made:

   (a) dismissing the motion of SFC in respect of the claims of E&Y;

   (b) declaring that the claims of E&Y against SFC are not "equity claims" within the definition of section 2 of the CCAA;

   (c) declaring that the claims of E&Y against SFC are "unsecured creditor" claims within the definition of section 2 of the CCAA; and

   (d) directing that the claims of E&Y against SFC must be determined and valued in accordance with the claims process established in the Claims Procedure Order (defined below) made in this proceeding.

PART II - OVERVIEW

3. This appeal concerns the definition of "equity claims" under the CCAA, as amended. On the motion below (the "**Equity Claims Motion**"), SFC sought a legal interpretation of "equity claims".

4. The motions judge misinterpreted the definition of "equity claims" in the CCAA. He wrongly concluded that the claims of the Company's auditors were equity claims – in effect the claims of shareholders.

5. This is the first appellate review of this language since it came into effect in 2009. The result is of central importance:

(a) to E&Y in this proceeding, since the practical effect of the order appealed from is that E&Y will recover nothing on its claims, as they will be subordinated to the claims of all creditors (unsecured and secured);

(b) to Canadian corporate and insolvency law generally; and

(c) to the issues of auditor liability and risk allocation in Canada.

6. The result below stems from a fundamental misinterpretation of the relationship between auditor and client. It is not equated with a shareholder, whose fortunes rise and fall with those of the corporation. E&Y never agreed to assume that risk as independent auditor.

7. The motions judge made reviewable errors of substance and process when concluding that any and all claims of E&Y related to the claims of shareholders were equity claims.

A. Substantive Errors

8. The motions judge was wrong to conclude that E&Y's claim for indemnification was "in respect of an equity interest" as defined in section 2 of the CCAA. In coming to that conclusion, the motions judge erred by:

(a) finding that the claims of an auditor (an arm's length third party) for indemnification are in respect of an equity interest held by such claimants;

(b) failing to find that the "contribution and indemnity" referred to at subsection (e) of the definition of "equity claim" refers to contribution and indemnity claims by a holder of equity interests, such as shareholders and not arm's length third parties such as auditors;

(c) failing to apply principles of statutory interpretation by reaching a conclusion that the September 2009 amendments substantially altered the pre-existing law to subordinate as "equity claims" the claims of an auditor, an arm's length third party, for indemnification, when there was an alternate, more correct, interpretation of the amendment which would have been consistent with the underlying policy of the amendment and the previous case-law;

(d) finding that the characterization of the claims of an auditor for indemnity turns on the nature of the damages that trigger the claim for indemnity, as opposed to the nature and origin of the indemnity claim in contract, statute or at common law, as an obligation of the Company arising out of a third party agreement to provide audit services. An auditor who has

contractual, statutory or common law indemnities related to its services does not hold an "equity claim", but is an unsecured creditor; and

(e) concluding that to consider the claims of an auditor for indemnification as general unsecured claims (and not equity claims) would put shareholders in a position to achieve creditor status by proxy. Any recovery by SFC's shareholders against E&Y is wholly independent of any recovery by E&Y against SFC for contribution and indemnity. It is E&Y that will not recover its losses if its claim for indemnity is denied, not the shareholders.

B. Procedural Error

9. The motions judge erred in not finding that the Equity Claims Motion was brought prematurely, in advance of the claims process set out in the "Claims Procedure Order" made May 14, 2012.

10. The Claims Procedure Order established a procedure to identify and address, among other things, the issue of whether a claim is or is not an "equity claim". The motions judge ought to have declined to hear the Equity Claims Motion until SFC and the Monitor gave effect to the Claims Procedure Order.

PART III - SUMMARY OF THE FACTS

A. Background

11. E&Y was retained as SFC's auditor for fiscal years 2007-2010.

Reference Description of Claim of E&Y, attached as Exhibit A (Schedule A2) to the Affidavit of Christina Shiels sworn

June 21, 2012 ("**Shiels Affidavit**"), Appeal Book and Compendium of E&Y, Tab 7AA2, at para. 1

12. On June 2, 2011, a short-seller, Muddy Waters LLC, issued a report which purported to reveal alleged fraud at the Company and cast various aspersions on the Company's advisors. In the wake of that report, Sino-Forest's share price plummeted and Muddy Waters profited handsomely from its short position.

Reference Fourth Report of the Monitor, July 10, 2012, Motion Record of the Underwriters Named in Class Actions (Motion Seeking Leave to Appeal), Tab 8, para 10

13. E&Y was served with a multitude of class action claims in numerous jurisdictions including Ontario and Quebec (the **"Class Actions"**).

Reference Description of Claim of E&Y, attached as Exhibit A (Schedule A2) to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7AA2, at paras. 11-14

14. The plaintiffs in the Ontario Class Action claim damages in the aggregate, and against all defendants, of $9.2 billion on behalf of resident and non-resident shareholders and noteholders. The causes of action alleged are both statutory, under the *Securities Act (Ontario)*, and at common law, in negligence and negligent misrepresentation. The central claim is that Sino-Forest and its advisors, including the auditors and underwriters, misrepresented that the Company's financial statements complied with generally accepted accounting principles. The claims against E&Y and the other third party defendants are that they failed in their gatekeeping function. Similar claims are advanced in the Quebec and U.S. actions.

Reference Particularized Claim, attached as Exhibit A (Schedule A1) to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7AA1, at para. 6

15. On March 30, 2012, the CCAA Court granted the Initial Order, which stayed the

proceedings. On April 13, 2012, the CCAA Court extended the Stay until June 1, 2012, and on May 31, 2012 extended the stay to September 28, 2012. On May 8, 2012, the CCAA Court ordered that the Stay extend to the third party defendants to the Ontario Class Action, including E&Y.

Reference Fourth Report of the Monitor, July 10, 2012, Motion Record of the Underwriters Named in Class Actions (Motion Seeking Leave to Appeal), Tab 8, para 1

Initial Order of Justice Morawetz, March 30, 2012, Appeal Book and Compendium of E&Y, Tab 4

16. On May 14, 2012, the CCAA Court issued an order (the "**Claims Procedure Order**") setting out the manner in which creditors' claims against SFC would be dealt with and addressed in the context of SFC's CCAA proceedings. The Claims Procedure Order was issued following the presentation by SFC of a motion in this regard which proceeded on an unopposed basis following extensive discussions amongst the stakeholders including, *inter alia*, SFC, E&Y, the Class Action plaintiffs and the other Class Action defendants.

17. Pursuant to the Claims Procedure Order:

(a) Proofs of Claim were directed to be filed with the Monitor by any party advancing a claim be filed by no later than June 20, 2012;

(b) the Monitor, in consultation with the Applicant and the directors and officers named in the Proof of Claim as applicable, shall review all Proofs of Claim and D&O Proofs of Claim;

(c) the Monitor may attempt to resolve any claims and may by notice in writing revise or disallow in whole or in part the amount and/or status of any Proof of Claim or D&O Proof of Claim;

(d) where a purported Proof of Claim or D&O Proof of Claim is revised or disallowed, the Monitor shall deliver to the Claimant a notice of revision or disallowance attaching a form of Dispute Notice (as defined in the Claims Procedure Order);

(e) in respect of any Proof of Claim or D&O Proof of Claim that exceeds $1 million, the Monitor and the Applicant shall not accept, admit, settle, resolve, value (for any purpose), revise or reject such Proof of Claim or D&O Proof of Claim without order of the Court; and

(f) a Claimant who intends to dispute a notice of revision or disallowance shall file a dispute notice with the Monitor, and failing a resolution or settlement of such disputed claim, the Monitor shall seek direction from the Court on the correct process for the resolution of the dispute. Without limitation, this "includes any dispute arising as to whether a claim is or is not an 'equity claim' as defined in the CCAA".

18. In accordance with the Claims Procedure Order, E&Y filed with the Monitor a Proof of Claim against SFC and its subsidiaries and a Proof of Claim against the directors and officers of SFC and its subsidiaries on June 20, 2012.

B. E&Y's Proof of Claim against Sino-Forest Corporation

19. E&Y makes contractual claims of indemnification against SFC and its subsidiaries for all relevant years, in respect of its annual audits as well as related to prospectuses and debt offerings. E&Y has statutory and common law claims of contribution and/or indemnity against SFC and its subsidiaries for all relevant years. In the E&Y Proof of Claim, E&Y makes has stand-alone claims for breach of contract, negligent and/or fraudulent misrepresentation and other tortious acts against the Company and its directors and officers.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7A

20. In the E&Y Proof of Claim, E&Y claims as against SFC and the SFC Subsidiaries and the directors and officers for:

(a) Indemnification and damages for:

(i) Breach of contract;

(ii) Negligent misrepresentation;

(iii) Fraudulent misrepresentation;

(iv) Inducing breach of contract (as against the SFC Subsidiaries only);

(v) Injury to reputation; and

(vi) Vicarious liability;

(b) Contractual indemnity, pursuant to E&Y's engagement letters; and

(c) Contribution and indemnity under the *Negligence Act*, R.S.O 1990, c. N-1 and other applicable legislation outside Ontario (the "***Negligence Act***").

21. The relationship between E&Y on the one hand, and SFC, the SFC Subsidiaries and their respective directors and officers on the other, was at all material times at arm's length. E&Y contracted with SFC to provide it with auditing services upon terms established by a series of engagement letters (the "**Engagement Letters**") for 2007 through and including 2010.

Reference Engagement Letters, attached at Exhibit A (Schedule C) to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7AC

22. E&Y had a direct professional relationship with SFC and with each of the SFC Subsidiaries.

23. E&Y as auditor of SFC did not have any relationship with the equity or debt holders of SFC in their capacity as security holders of SFC. E&Y is not and has never been a shareholder, other equity holder or a holder of funded debt of SFC or any SFC Subsidiary.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7A

C. The Decision Below

24. By way of Notice of Motion dated June 8, 2012 (and seeking a hearing date of June 15, 2012), the Applicant brought a motion seeking an order directing that the anticipated claims of the plaintiffs in the Class Actions and the anticipated claims for contribution and indemnity of E&Y and other third parties were "equity claims" under the CCAA (the "Equity Claims Motion"). The claims bar date under the already existing Claims Procedure Order was June 20, 2012. The Equity Claims Motion was brought in an evidentiary vacuum and notwithstanding the fact that the Claims Procedure Order expressly provided that the nature, quality or quantity of the claims against the Applicant were to be determined in the context of the claims process. No such determination was (or has to date) been made.

25. The Company and the Monitor advised that the Order sought would not apply to SFC's subsidiaries.

26. The Equity Claims Motion was heard on June 26, 2012.

27. By way of endorsement and Order dated July 27, 2012, the motions judge granted the

Equity Claims Motion in part and concluded that:

(a) The Equity Claims Motion was not premature notwithstanding the terms of the Claims Procedure Order;

(b) The claims of SFC's shareholders against the Applicant are "equity claims" under section 2 of the CCAA;

(c) The most significant portion of the claims of E&Y against SFC as well as those of BDO and the Underwriters should be characterized as "equity claims" under section 2 of the CCAA, insofar as they are "being used to recover an equity investment" and relate to the claims brought by SFC's shareholders; and

(d) Defence costs incurred and to be incurred by E&Y in defending the Class Actions may not necessarily constitute equity claims insofar as they may not be "in respect of an equity claim" should the shareholders be ultimately unsuccessful.

28. In coming to these conclusions, the motions judge held, *inter alia*, that:

(a) The plain language of section 2(1)(e) of the CCAA leads to the conclusion that those claims of E&Y constitute a "contribution or indemnity" in respect of Shareholder Claims which themselves constitute equity claims under section 2(1)(d) of the CCAA;

(b) "[I]t would be totally inconsistent… to enable the auditors or the Underwriters, through a claim for indemnification to be treated as creditors when the underlying actions of the shareholders cannot achieve the same status". Such treatment "would potentially put the shareholders in a position to achieve creditor status through their claims against E&Y, BDO and the Underwriters"; and

(c) "[S]uch claim is being used to recover an equity investment".

PART IV - LAW AND ARGUMENT

A. The Issues

29. This appeal raises the following issues:

(a) Whether the motions judge erred by finding that the claims of E&Y for indemnification are claims "in respect of an equity interest"; and

(b) Whether the Equity Claims Motion was premature and therefore whether the motions judge erred in making the Order.

B. The Standard of Review

30. The motion concerned the interpretation of the definition of "equity claims" under the CCAA. This issue now comes before this Honourable Court as a matter of first impression. As a purely legal issue, the standard of review is correctness.

Reference *ATB Financial v. Metcalf & Mansfield Alternative Investments II Corp.*, 2008 ONCA 587 at para. 40, leave to appeal refused, [2008] S.C.C.A. No. 337, Brief of Authorities of the Appellant Ernst & Young LLP ("E&Y Brief of Authorities") at Tab 1.

Alternative Fuel Systems Inc. v. Remington Development Corp., 2004 ABCA 31 at para. 9, E&Y Brief of Authorities at Tab 2.

C. Issue 1 - The motions judge erred in concluding that the claims of E&Y are in respect of an equity interest

31. The provisions of the CCAA dealing with "equity claims" were introduced in 2007 by Bill C-12 and proclaimed in force in September of 2009 as part of a broad reform of Canadian insolvency legislation.

Reference Bill C-12, *An Act to Amend the Bankruptcy and Insolvency Act, the Companies' Creditors*

Arrangement Act, the Wage Earner Protection Act and chapter 47 of the Statutes of Canada, s. 105 (the "Act"), Schedule B.

32. The plain language of "equity claim" in section 2 (e) of the CCAA is clear and unambiguous and must be the starting point of any analysis as to the scope of such definition:

> "equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
>
> (b) a return of capital,
>
> (c) a redemption or retraction obligation,
>
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
>
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d);
>
> [...]
>
> "equity interest" means
>
> (a) in the case of a company other than an income trust, a share in the company — or a warrant or option or another right to acquire a share in the company — other than one that is derived from a convertible debt, and
>
> (b) in the case of an income trust, a unit in the income trust — or a warrant or option or another right to acquire a unit in the income trust — other than one that is derived from a convertible debt;
>
> [Emphasis added]

Reference Section 2 of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, C-36, Schedule B

Nelson Financial Group Ltd., 2010 ONSC 6229 at para. 34, E&Y Brief of Authorities at Tab 3.

33. A plain reading of the definition of "equity claim" leads to the conclusion that the claims of E&Y against SFC could not be captured by it:

(a) E&Y is not a shareholder of SFC. Its claims are not related to shares, warrants or options issued by SFC in its favour;

(b) E&Y's claim for contribution and indemnity is not made "in respect of a claim referred to in any of subparagraphs (a) to (d)". The damages which underlie E&Y's claim for contribution and indemnity against the Applicant SFC are not the "claims" referred to in paragraph (e):

(i) "Claim" is a defined term:

> "claim" means any indebtedness, liability or obligation of any kind that would be a claim provable within the meaning of section 2 of the Bankruptcy and Insolvency Act.
>
> **Reference** *Companies' Creditors Arrangement Act*, R.S.C. 1985, C-36, Schedule B.

(ii) Sections 2 and 121 of the BIA provide that a "provable claim in bankruptcy" is a claim which is asserted against the bankrupt, not against a third party:

> 121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt (...) shall be deemed to be claims provable in proceedings under this Act.
>
> **Reference** *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, Schedule B.

(c) The shareholders' action against E&Y for damages as a result of a "monetary loss resulting from the ownership, purchase or sale of an equity interest" is a claim against E&Y in a court proceeding. It is not a "claim" against the bankrupt Applicant under insolvency legislation.

34. The claims of E&Y against SFC are not captured by the definition of "equity claim", at paragraph (e) or otherwise.

35. This interpretation is consistent with:

(a) the nature of the claim made by E&Y; and

(b) principles of statutory interpretation, which dictate that an interpretation consistent with pre-existing case-law and legislative intent can and should be made.

(a) Nature of E&Y's claims are that of an unsecured creditor

36. When analyzing the nature of a claim, the Courts have considered the substance of the relationship between a claimant and the debtor company, including the contractual documents governing the parties' relations, as well as the parties' intentions.

Reference *Nelson Financial Group Ltd., supra,* at para. 34, E&Y Brief of Authorities at Tab 3.

Central Capital Corp. 1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at paras. 116, 119, 120, E&Y Brief of Authorities at Tab 4.

Re Blue Range Resource Corporation, 200 ABQB 4 at para. 26, E&Y Brief of Authorities at Tab 5.

37. The relationship between E&Y and SFC has always been purely contractual. E&Y contracted with SFC to provide auditing services on terms established by its "Engagement Letters" for 2007-2010.

38. The Engagement Letters stipulate that E&Y was retained as an independent service provider to be paid based upon a fixed or an hourly basis, and in any case entirely independently of SFC's revenues or financial performance.

Reference Terms and conditions of Engagement Letters dated: March 30, 2004, s.21; April 26, 2004, s.22; August 6, 2004, s. 22; September 30, 2004, s.22; December 15, 2004, s.24; December 21, 2005, s. 23; June 21, 2007, s. 21; February 5, 2008, s. 19;

April 16, 2008, s.21; April 16, 2008, s.21; April 16, 2008, s.21; April 16, 2008, s.21; May 7, 2008, s.21; May 7, 2008, s.21; July 4, 2008, s. 21; August 7, 2008, s.21; August 18, 2008, s.22; January 6, 2009, s.21; January 6, 2009, s.21; May 17, 2009, s.20; October 1, 2009, s.20; November 9, 2009, s.19; November 17, 2009, s.20; November 17, 2009, s.20; November 17, 2009, s.20; and, March 22, 2010, s.20. Engagement Letters, attached at Exhibit A (Schedule C) to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7AC

39. E&Y's remuneration has never been dependent upon SFC's profits.

40. E&Y has never been a shareholder of SFC or of any SFC Subsidiary and nor did it ever hold any equity of SFC or any SFC Subsidiary. E&Y did not assume any of the risk associated with being a shareholder of SFC.

41. E&Y contracted for remuneration for its services and expected to receive such remuneration from SFC, independent of SFC's financial performance. E&Y's bargain with SFC is that of a creditor.

42. The policy reasons related to the assumption of risk, business expectations, and the corporate law ordering of the ranking between creditors and shareholders would not be furthered by the characterization of E&Y's claim as an equity claim.

43. An auditors' fortunes do not (and cannot for reasons of professional responsibility) rise and fall with the company to be audited. With this result, an auditor faces the downside risk of the company's fortunes with no corresponding participation in its success. Neither concept is consistent with the audit relationship.

44. While "equity investors bear the risk relating to the integrity and character of management" and "tie their investment to the fortune of the corporation", the same is not true for

an auditor:

> Historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. As noted by Laskin J.A. in Re Central Capital Corporation, on the insolvency of a company, the claims of creditors have always ranked ahead of shareholders for the return of capital. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of the shareholders in insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of management. [Emphasis added]

Reference *Nelson Financial Group, supra,* at para. 25, E&Y Brief of Authorities at Tab 3.

45. The subordination of E&Y's claim would not further the legislative purposes of the 2009 amendment to subordinate shareholder recovery since E&Y's relationship with SFC is not in the nature of a shareholder-issuer relation but rather in the nature of a debtor-creditor relationship.

46. As set out in its Proof of Claim, E&Y contracted for indemnification from SFC in respect of its audit work. E&Y also has rights of indemnity at statute, pursuant to the *Negligence Act*, and common law.

47. E&Y's claims includes claims for common law indemnification founded on breaches of contract and tort – separate and actionable causes of action.

48. A significant component of E&Y's claims are: (a) for breach of contract, arising from SFC's violation of the terms of the Engagement Letters pursuant to which SFC undertook to provide E&Y with complete and full disclosure of its financial information; (b) fraudulent and negligent misrepresentation as against SFC; and (c) SFC's vicarious liability for the misrepresentations of its directors, officers, employees and agents and those of the SFC Subsidiaries.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Appeal Book and Compendium of E&Y, Tab 7A, paras. 28-56

49. The motions judge discounted these claims to zero. The motions judge erred in so doing.

(b) Principles of statutory interpretation should lead to a consistent result

50. It is a well-founded principle of statutory interpretation that it is assumed that the legislature does not intend to alter the common law without "irresistible clearness" of such an intention:

> To begin with, I think it useful to stress the presumption that the legislature does not intend to change existing law or to depart from established principles, policies or practices. In *Goodyear Tire & Rubber Co. of Canada v. T. Eaton Co.*, [1956] S.C.R. 610, at p. 614, for example, Fauteux J. (as he then was) wrote that "a Legislature is not presumed to depart from the general system of the law without expressing its intentions to do so with irresistible clearness, failing which the law remains undisturbed". In *Slaight Communications Inc. v. Davidson,* [1989] 1 S.C.R. 1038, at p. 1077, Lamer J. (as he then was) wrote that "in the absence of a clear provision to the contrary, the legislator should not be assumed to have intended to alter the pre-existing ordinary rules of common law".

Reference *Parry Sound (District) Social Services Administration Board v Ontario Public Service Employees Union, Local 324*, [2003] S.C.J. No. 42, para 39 (S.C.C.), E&Y Brief of Authorities at Tab 6.

Ruth Sullivan, *Sullivan on the Construction of Statutes* (Markham: LexisNexis Canada Inc., 2008) at 431, E&Y Brief of Authorities at Tab 7.

51. The motions judge purported to adhere to this principle, but was inconsistent in his application of the pre-existing case-law which he found to be codified by the amendments to the CCAA. The motions judge did so when an alternate, and consistent, interpretation of the "equity claims" definition was available to him. The motions judge also made his finding without

"irresistible clearness" of intention from the legislature to alter the pre-existing common law.

Reference Endorsement of Justice Morawetz dated July 27 2012, Appeal Book and Compendium of E&Y, at paras. 78, 86-89

(i) Pre-existing case-law did not subordinate claims of auditors

52. In decisions prior to the 2009 legislative amendments, the Courts held in the context of insolvency proceedings that:

(a) Claims by shareholders seeking to recover the loss of share value or other shareholder interest ought to be subordinated to unsecured claims, regardless of the legal basis of such claims;

Reference *Re Blue Range Resources, supra,* at para. 57, E&Y Brief of Authorities at Tab 5.

National Bank of Canada v. Merit Energy Ltd., 2001 ABQB 583, at para. 55, E&Y Brief of Authorities Tab 8.

(b) Claims by shareholders pursuant to indemnity agreements with a debtor company, whereby the latter is obligated to indemnify shareholders, ought to be subordinated; and

Reference *National Bank of Canada v. Merit Energy Ltd., supra*, at paras. 39, 51 to 55, E&Y Brief of Authorities at Tab 8.

Re Earthfirst Canada Inc., 2009 ABQB 316, at para. 5. E&Y Brief of Authorities Tab 9.

(c) Claims by third parties, including auditors, seeking indemnification from the debtor company for litigation relating to its shares, were not subordinated and ranked equally with unsecured claims.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 72 and 80, E&Y Brief of

Authorities at Tab 8.

53. It is settled law that the interests of shareholders are subordinated to the interests of creditors in insolvency proceedings, regardless of the nature of their claims, for the following reasons:

(a) Recovery by shareholders on a *pari passu* basis with creditors would contravene the fundamental corporate law principle that a claim in damages by a shareholder for a return of the amount paid for the shares should rank below creditors in an insolvency;

(b) The expectation of creditors who conduct business with corporations upon the assumption that they would be given priority over the shareholders should not be disturbed;

(c) The investment of shareholders is inherently a risky one compared to creditors' interest to receive payment. Accordingly, it is equitable to impose the risk of fraud on the shareholders; and

(d) Recovery by shareholders on a *pari passu* basis with creditors would open the floodgates to tort claims by shareholders in the context of CCAA proceedings.

Reference *Re Blue Range Resources, supra,* at paras. 29-57, E&Y Brief of Authorities at Tab 5.

54. The pre-amendment case law is consistent with the amendments of 2009 not altering the common law. The pre-existing case-law subordinated:

(a) Claims for a dividend or similar payment;

Reference *Re Blue Range Resources*, *supra*, at para. 57, E&Y Brief of Authorities at Tab 5.

National Bank of Canada v. Merit Energy Ltd., supra, at para. 55, E&Y Brief of Authorities at

Tab 8.

JED Oil Inc. (Re), 2010 ABQB 295, E&Y Brief of Authorities, Tab 10.

Dexior Financial Inc. (Re), 2011 BCSC 348 at paras. 3, 17-20, E&Y Brief of Authorities at Tab 11.

(b) Claims for a return of capital;

Reference *Re Blue Range Resources*, *supra*, at para. 57, E&Y Brief of Authorities at Tab 5.

(c) Claims for a redemption or retraction obligation;

Reference *Central Capital Corp.*, *supra*, E&Y Brief of Authorities at Tab 4.

Dexior Financial Inc. (Re), *supra*, at paras. 3, 17-20, E&Y Brief of Authorities at Tab 11.

(d) Claims for monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission of a purchase or sale of an equity interest;

Reference *National Bank of Canada v. Merit Energy Ltd.*, *supra*, E&Y Brief of Authorities at Tab 8.

Dexior Financial Inc. (Re), *supra*, at paras. 3, 17-20, E&Y Brief of Authorities at Tab 11.

(e) Contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).

Reference *EarthFirst Canada Inc. (Re)*, *supra*, at para. 4, E&Y Brief of Authorities at Tab 9.

55. Since the amendments, Courts have held that the amendments of 2009 codified the historical treatment of equity claims.

Reference *Nelson Financial Group Ltd., supra*, at para. 27, E&Y Brief of Authorities at Tab 3.

Dexior Financial Inc. (Re), supra, at para. 17, E&Y Brief of Authorities at Tab 11.

56. In *Merit Energy Ltd.*, the Alberta Court of Queen's Bench refused to subordinate the claims of the auditor which sought to recover its losses based on an indemnity agreement. The Court held that the subordination of the claims of such third parties would in no way further the policy principles that grounded the decision of Romaine J. in *Re Blue Range Resources*, since:

(a) The shareholders' claim against each of the directors, underwriters and auditors is distinct from the claims of the latter against the debtor company. As such, the shareholders are "strangers" to the claims of those third parties against the debtor company. Accordingly, the obligation of the debtor company to indemnify its directors, underwriters and auditors is not "in respect of" a shareholder's interest;

(b) Underwriters, directors and auditors are creditors of the debtor company who do not assume the risk assumed by shareholders; and

(c) Allowing the claims of underwriters, directors and auditors would not open the floodgates to claims by shareholders in CCAA proceedings, since such parties are not shareholders.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 62 to 72, 79 to 81, E&Y Brief of Authorities at Tab 8.

57. The Alberta Court also dismissed the argument, upheld here by the motions judge, that the recovery by third parties of indemnity claims on a *pari passu* basis with unsecured claims would allow the shareholders to recover indirectly from those indemnified parties what they could not recover directly from the company.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 69 to 72, E&Y Brief of Authorities at Tab 8.

58. The Alberta Court held that such an argument erroneously assumed that the success of the shareholders against the indemnified party was contingent upon success by the indemnified parties against the applicant.

59. The decision of the Alberta Court was upheld by the Alberta Court of Appeal which came to the conclusion that "the tests used by the Chambers judge to characterize the claims were the appropriate ones".

Reference *Delf v. Merit Energy Ltd.*, 2002 ABCA 5, at para. 2, E&Y Brief of Authorities, Tab 11, E&Y Brief of Authorities at Tab 12.

60. The motions judge did not analyze the policy considerations which led the Alberta Court in *Merit Energy* to conclude that the claims of indemnified auditors against the company should not be subordinated nor treated like the claims of shareholders indemnified by the company. The motions judge made contrary findings.

61. *Return on Innovations v. Gandi Innovations*, the only applicable Canadian decision rendered after the coming into force of the equity claims 2009 CCAA amendment, although the new provisions did not apply to it due to the timing of the initial CCAA order. It dealt with the indemnification claims of directors, not third parties such as auditors.

Reference *Return on Innovations* v. *Gandi Innovations*, 2011 ONSC 5018 ("*Return on Innovations*") at para. 55, E&Y Brief of Authorities, Tab 13.

62. The motion in *Return on Innovations* was not argued on the basis that the claims for indemnification by the directors and officer were not "equity claims". The motion was argued on the basis that the underlying claims for damages by an equity investor (TA Associates Inc.) against the directors and officers were not equity claims because they were advanced as claims for breach of contract and in tort. That distinction was correctly rejected by Newbould J. That finding is consistent with prior case-law and with the legislative intent behind the amendments to the CCAA.

63. In any event, this Court confirmed in its endorsement denying leave to appeal that the decision:

(a) should not be read as judicial precedent for the interpretation of the term "equity claims" within the meaning of section 2 of the amended CCAA; and

(b) was confined to the facts in the case and that "[t]o the extent that existing case law continues to govern whatever pre-September 2009 insolvency proceedings are still in the system, those cases will fall to be decided on their own facts."

Reference *Return on Innovations,* 2012 ONCA 10, at para. 12, E&Y Brief of Authorities, Tab 14.

64. To the extent that *Return on Innovations* is urged upon this Court to be applicable not only to the characterization of the underlying shareholder claims and beyond director and officer claims to arm's length third parties such as E&Y, the decision is wrong in principle.

65. Indeed, the Applicant SFC has not sought to limit the indemnifications of its directors and officers in respect of the Class Action shareholder claims. Their claims did not form part of relief sought by the Applicant's Equity Claims Motion.

66. The plain language used at subsection (e) of the "equity claim" definition in the CCAA ("indemnity in respect of an equity interest") supports an interpretation which essentially codifies and is consistent with the *rationale* and result of the *Merit Energy* and *EarthFirst* decisions: section 2(1)(e) should only apply where the indemnity is in favour of a shareholder (or similar equity holder), not where the indemnity is in favour of an independent third party such as E&Y as auditor.

(ii) The Legislative Purpose behind the 2009 Amendments to the CCAA

67. Parliament and the Senate considered the policy reasons for subordinating shareholder claims when debating the amendment to the CCAA.

68. The Senate Committee Report set out the policy rationale for its recommendation to amend insolvency legislation to subordinate shareholder claims as follows:

> [S]ince holders of equity have necessarily accepted – through their acceptance of equity rather than debt – that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently, their claims should be afforded a lower ranking than secured and unsecured creditors, and the law – in the interests of both fairness and predictability – should reflect both the lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full.

Reference Senate Committee on Banking, Trade and Commerce, Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act (the "Senate Committee Report") (2003) at 159, E&Y Brief of Authorities at Tab 15.

69. To that end the Senate Committee Report recommended that insolvency legislation "be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not participate in the proceeds of a restructuring or bankruptcy until other creditors have been paid in full." [Emphasis added]

Reference Senate Committee Report, supra at 159, E&Y Brief of Authorities at Tab 15.

70. Although the Senate Committee Report refers to U.S. insolvency legislation, it does not recommend a wholesale importation of U.S. legislation or jurisprudence. In any event, a close study of the American legislation and jurisprudence leads to the conclusion that it is fundamentally different on the issue in Canada. Further, no U.S. court has found an auditor's claim to be an "equity claim"

71. The clause-by-clause analysis of Bill C-12 echoes the policy rationales for the amendment espoused by the Senate Committee:

> The definition of "equity claim" is added to provide greater clarity in subsequent provisions that deal with the rights of shareholders.
>
> **Reference** Bill C-12, Clause-by-Clause Analysis, s. 105, E&Y Brief of Authorities at Tab 16.
>
> The amendment is one of several that are made with the intention of clarifying that equity claims are to be subordinate to other claims. Equity claims are ownership interests and, as such, should be subject to the risks

of insolvency. [emphasis added]

Reference Bill C-12, Clause-by-Clause Analysis, *supra*, s. 71, E&Y Brief of Authorities at Tab 16.

72. The Hansard transcript of the debate of Bill C-12 in the Senate Committee on Banking, Trade and Commerce, following Bill C-12's third reading by the House of Commons, makes it abundantly clear that section (e) of the definition of "equity claim" is intended to capture indemnity claims by shareholders:

> [A] definition of "equity claim" has been introduced. This clarifies that equity claims include items like dividend payments, return of capital, a right to have the company buy back your shares, a loss on the value of your shares and the right to be indemnified by the company for losses on the value of those shares. [Emphasis added]

Reference Senate of Canada, Proceedings of the Standing Committee on Banking, Trade and Commerce, 39th Parl., 2nd Sess., No 2 (29 November 2007) at 2:26 (Colin Carrie), E&Y Brief of Authorities at Tab 18.

73. Prior to the Order appealed from, Canadian authors concluded that the amendments of 2009 related to the definition of equity claim in the CCAA incorporated the historical treatment of equity claims by Canadian Courts.

Reference Golick, Steven G. and Edward Sellers, "Corporate Governance" in Ben-Ishai, Stephanie and Duggan, Anthony (eds.), *Canadian Bankruptcy and Insolvency Law : Bill C-55, Statute C. 47 and Beyond*, Lexis Nexis, Toronto, 2007, pp. 255-271, p. 267, E&Y Brief of Authorities, Tab 19.

Richard H. McLaren, *Canadian Commercial Reorganization : Preventing Bankruptcy*, vol. 2, Thomson Reuters, Toronto, p. 5-26.3, para. 5.2075 (Loose-leaf dated June 2012), E&Y Brief of Authorities, Tab 17, E&Y Brief of Authorities at Tab 20.

Lazar Sarna, *Law of Bankruptcy and Insolvency in*

Canada, Lexis Nexis, Toronto, 2012, §7.3.a.ii, E&Y Brief of Authorities, Tab 21.

Janis Sarra, "From Subordination to Parity : An International Comparison of Equity Securities Law Claims in Insolvency Proceedings", *supra*, pp. 208-210, E&Y Brief of Authorities at Tab 27.

D. Issue 2 - The Order was premature

74. As outlined above, on May 14, 2012, the CCAA Court granted the Claims Procedure Order on an unopposed basis.

75. E&Y, as other creditors of SFC, duly filed its proofs of claim in the CCAA proceedings pursuant to the Claims Procedure Order, on the basis that the nature of its rights resulting from such claims against SFC would be determined in accordance with the Claims Procedure Order.

76. However, prior to the receipt of E&Y's proofs of claim and thus any determination of those proofs of claim, SFC, supported by the Monitor, effectively pre-empted the Claims Procedure Order (which it had sought and negotiated with the respondents so it could proceed unopposed) and brought the Motion in order to pre-determine whether or not the claim that had yet to be filed by E&Y constitutes an "equity claim" as defined under CCAA, all without any evidentiary basis. That decision, although discretionary, was wrong in principle.

PART V - RELIEF REQUESTED

77. For the reasons outlined above, E&Y respectfully requests an Order:

(a) dismissing the Motion brought by SFC;

(b) finding that the claims of E&Y against SFC are not "equity claims" within the definition of section 2 of the CCAA;

(c) finding that the claims of E&Y against SFC are "unsecured creditor" claims within the definition of section 2 of the CCAA;

(d) directing that the claims of E&Y against SFC must be dealt with and valued in accordance with the claims process set out in the Claims Procedure Order; and

(e) granting E&Y its costs of the Appeal and the Motion appealed from.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 26th day of October, 2012.

Peter H. Griffin

Peter J. Osborne

Shara N. Roy

LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax: (416) 865-3974
Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax: (416) 865-3973

Lawyers for the Appellant, Ernst & Young LLP

Court of Appeal File No. M41654
Superior Court File No. CV-12-9667-00-CL

COURT OF APPEAL FOR ONTARIO

IN THE MATTER OF THE *COMPANIES CREDITORS' ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT IN THE MATTER OF SINO-FOREST CORPORATION

Applicant

APPLICATION UNDER THE *COMPANIES CREDITORS' ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

CERTIFICATE

An order under Rule 61.09(2) (original record and exhibits) is not required.

October 26, 2012

Shara N. Roy

LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax: (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax: (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant
Ernst & Young LLP

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COMMERCIAL LIST

PROCEEDING COMMENCED AT TORONTO

CERTIFICATE

LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant, Ernst & Young LLP

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I estimate that **2.5 hours** will be needed for the appellants' oral argument of the appeal, not including reply. An order under 61.09(2) (original record and exhibits).

October 26, 2012

Peter H. Griffin

LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax: (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax: (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant
Ernst & Young LLP

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LENCZNER SLAGHT ROYCE SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant, Ernst & Young LLP

SCHEDULE "A"

LIST OF AUTHORITIES

1. *ATB Financial v. Metcalf & Mansfield Alternative Investments II Corp.*, 2008 ONCA, 587.

2. *Alternative Fuel Systems Inc. v. Remington Development Corp.*, 2004 ABCA 31.

3. *Nelson Financial Group Ltd.*, 2010 ONSC 6229.

4. *Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.).

5. *Re Blue Range Resource Corporation*, 2000 ABQB 4.

6. *Parry Sound (District) Social Services Administration Board v Ontario Public Service Employees Union, Local 324*, [2003] S.C.J. No 42 (S.C.C.).

7. Ruth Sullivan, *Sullivan on the Construction of Statutes* (Markham: LexisNexis Canada Inc., 2008).

8. *National Bank of Canada v. Merit Energy Ltd.*, 2001 ABQB 583.

9. *Re Earthfirst Canada Inc.*, 2009 ABQB 316.

10. *JED Oil Inc. (Re)*, 2010 ABQB 295.

11. *Dexior Financial Inc. (Re)*, 2011 BCSC 348.

12. *Delf v. Merit Energy Ltd.*, 2002 ABCA 5.

13. *Return on Innovations* v. *Gandi Innovations*, 2011 ONSC 5018.

14. *Return on Innovations v. Gandi Innovations,* 2012 ONCA 10.

15. Report of the Standing Senate Committee on Banking, Trade and Commerce, "Debtors and Creditors Sharing the Burden : A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*" (2003).

16. Bill C-12, Clause by Clause Analysis, Clause Nos. 71 and 105.

17. Janis Sarra, "From Subordination to Parity : An International Comparison of Equity Securities Law Claims in Insolvency Proceedings", *Int. Insolv. Rev.*, (2007) vol. 16.

18. Senate of Canada, Proceedings of the Standing Committee on Banking, Trade and Commerce, 39th Par 1., 2nd Sess, No. 2 (29 November 2007) at 2:26 (Colin Carnie).

19. Golick, Steven G. and Edward Sellers, "Corporate Governance" in Ben-Ishai, Stephanie and Duggan, Anthony (eds.), *Canadian Bankruptcy and Insolvency Law : Bill C-55, Statute C. 47 and Beyond*, Lexis Nexis, Toronto, 2007.

20. Richard H. McLaren, *Canadian Commercial Reorganization : Preventing Bankruptcy*, vol. 2, Thomson Reuters, Toronto, (Loose-leaf dated June 2012).

21. Lazar Sarna, *Law of Bankruptcy and Insolvency in Canada*, Lexis Nexis, Toronto, 2012, §7.3.a.ii.

SCHEDULE "B"

Bankruptcy and Insolvency Act

R.S.C., 1985, c. B-3

2. (1) In this Act,

[...]

"claim provable in bankruptcy", "provable claim" or "claim provable" includes any claim or liability provable in proceedings under this Act by a creditor;

[...]

121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

(2) The determination whether a contingent or unliquidated claim is a provable claim and the valuation of such a claim shall be made in accordance with section 135.

(3) A creditor may prove a debt not payable at the date of the bankruptcy and may receive dividends equally with the other creditors, deducting only thereout a rebate of interest at the rate of five per cent per annum computed from the declaration of a dividend to the time when the debt would have become payable according to the terms on which it was contracted.

(4) A claim in respect of a debt or liability referred to in paragraph 178(1)(b) or (c) payable under an order or agreement made before the date of the initial bankruptcy event in respect of the bankrupt and at a time when the spouse, former spouse, former common-law partner or child was living apart from the bankrupt, whether the order or agreement provides for periodic amounts or lump sum amounts, is a claim provable under this Act.

Companies' Creditors Arrangement Act

R.S.C., 1985, c. C-36

2. (1) In this Act,

[...]

"equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,

- (*a*) a dividend or similar payment,
- (*b*) a return of capital,
- (*c*) a redemption or retraction obligation,
- (*d*) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
- (*e*) contribution or indemnity in respect of a claim referred to in any of paragraphs (*a*) to (*d*);

"equity interest" means

- (*a*) in the case of a company other than an income trust, a share in the company — or a warrant or option or another right to acquire a share in the company — other than one that is derived from a convertible debt, and
- (*b*) in the case of an income trust, a unit in the income trust — or a warrant or option or another right to acquire a unit in the income trust — other than one that is derived from a convertible debt;

[...]

6. (8) This Act extends and does not limit the provisions of any instrument now or hereafter existing that governs the rights of creditors or any class of them and has full force and effect notwithstanding anything to the contrary contained in that instrument.

[...]

22.1 Despite subsection 22(1), creditors having equity claims are to be in the same class of creditors in relation to those claims unless the court orders otherwise and may not, as members of that class, vote at any meeting unless the court orders otherwise.

Bill C-12: An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005

e. Treatment of Equity Claims (Clauses 1(7), 19, 20, 49, 54, 69, 71, 99, 105 and 106)

Bill C-12 amends the BIA to exclude the entire class of creditors having "equity claims" from the right to vote on a proposal, unless the court orders otherwise (clauses 19 and 20, sections 54(2)(d) and 54.1).(23) The term "equity claim" has a broad definition under Bill C-12. An "equity claim" is a claim in respect of an equity interest, including a claim for one of the following:

- a dividend or similar payment;
- a return of capital;
- a redemption or retraction obligation;
- a monetary loss resulting from the ownership, purchase or sale of an equity interest, or from the rescission (or in Quebec, the annulment) of a purchase or sale of an equity interest; or
- a contribution or indemnity in respect of any of the above claims (clause 1(7), section 2).

The term "equity interest" is defined as a share in a corporation, or a unit in an income trust – or a warrant, option or another right to acquire a share or unit – other than one that is derived from a convertible debt (clause 1(7), section 2).

Bill C-12 stipulates that the court may not approve of a proposal that provides for the payment of an equity claim, unless the proposal states that all other claims are to be paid in full before the equity claims are paid (clause 99, section 60(1.7) BIA).

Note that in the case of bankruptcy, Bill C-12 amends the BIA to subordinate equity claims, as defined above, to all other claims in bankruptcy (clause 49, section 140.1 BIA). Thus, a creditor is not entitled to a dividend in respect of an equity claim unless all other claims have been satisfied.(24)

If the bankrupt is subject to a liability as a result of obtaining property or services by false pretences or fraudulent misrepresentation, a discharge in bankruptcy will not release him from that liability – unless the liability also arises from an equity claim (clause 54, section 178(1)(e) BIA).

Bill C-12 also makes corresponding amendments to the CCAA (clause 69, section 19(2)(d); clause 71, section 22.1; clause 105, section 124(3); and clause 106, sections 6(1) and (8)).

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APPELLANT'S FACTUM

LENCZNER SLAGHT ROYCE
SMITH GRIFFIN LLP
Barristers
Suite 2600
130 Adelaide Street West
Toronto ON M5H 3P5

Peter H. Griffin (19527Q)
Tel: (416) 865-2921
Fax: (416) 865-3558
Email: pgriffin@litigate.com

Peter J. Osborne (33420C)
Tel: (416) 865-3094
Fax (416) 865-3974
Email: posborne@litigate.com

Shara N. Roy (49950H)
Tel: (416) 865-2942
Fax (416) 865-3973
Email: sroy@litigate.com

Lawyers for the Appellant, Ernst & Young LLP